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AGENDA ITEM 4b

TO: MEMBERS OF THE INVESTMENT COMMITTEE

I. SUBJECT: Equity Real Estate Leverage Policy – CalPERS

II. PROGRAM: Real Estate – Core and Non Core Portfolios

III. RECOMMENDATION: To clarify the Statement of Investment Policy for Equity Real Estate Leverage and establish a limit of 25% of the Real Estate target allocation on recourse debt such as Lines of Credit and other credit accommodations which carry a CalPERS guarantee.

IV. ANALYSIS:

Affirmation and Recommendation:

Staff is presenting this item for two reasons:

1st) To affirm that the Investment Committee (IC) did approve the selective use of CalPERS guarantees on Lines of Credit or other financing vehicles when it is in CalPERS' economic benefit to do so and only when authorized by the SIO of Real Estate.

2nd) To establish an overall limit in the aggregate amount of CalPERS guarantees of the above type of debt instruments (exclusive of subscription facilities[1]). These guarantees will not, in the aggregate, exceed 25% of the real estate portfolio target allocation.

[1] The reason Subscription Lines of Credit facilities are excluded is because these are equity substitute facilities already accounted for in the equity allocation numbers that are tracked and reported to the Investment Committee annually in the real estate unit's annual plan.

Recently, when staff attempted to provide a CalPERS guarantee of a line of credit to one of CalPERS' partnerships, CalPERS' legal office felt that the authority to execute a guaranty in an amount in excess of CalPERS' capital commitment to the partnership was unclear due to discussion and subsequent questions raised when the subject item was presented at the November 15, 2004 IC meeting. Given this, staff is bringing the language that was approved both at the IC and in subsequent Policy Subcommittee meetings back to the IC to seek further clarification on the SIO's ability to selectively use CalPERS guarantees in situations where it is economically beneficial to CalPERS to do so.

Additionally, based on further internal discussions, the investment office feels that setting a limit on the aggregate amount of CalPERS real estate guarantees is prudent. Thus, staff is recommending the 25% limit noted above. Given the current fund size of $196 billion and the 8% real estate target, the current limit would be approximately $3.9 billion ($196 billion X 8% X 25%).

Such selective use of CalPERS guarantees provides substantial economic benefits to CalPERS' partnerships in that the partnership is able to borrow at a lower rate of interest, thereby adding hundreds of basis points to CalPERS' projected returns from its investment in the partnership. Staff will report to the IC on a quarterly basis within the performance report the total of such guarantees in the future.

If the 25% cap is approved, staff will present the needed Policy edits at the December 9, 2005, Policy Subcommittee.

<u>Background</u>

Staff amended and clarified Equity Real Estate Leverage Policy at the November 15, 2004, Investment Committee meeting. At that meeting, staff recommended and the IC approved amending the Equity Real Estate Leverage Policy. In addition, staff presented and received approval in first and second readings of the Equity Real Estate Leverage Policy by Investment Policy Subcommittee on December 10, 2004 and March 15, 2005, respectively. (See Attachment 1 for the current Equity Real Estate Leverage Policy.)

Below is an excerpt of the Collateral paragraph in the Real Estate Leverage Policy, identified in section III, paragraph B. The bold and underlined language is the language that was approved by the IC and Policy Subcommittee on the dates referenced above:

> Borrowings may be structured in public or private, and secured or unsecured formats; however, recourse shall be limited in all cases to the real estate investments in the portfolio. The System shall not **<u>generally</u>** guarantee such

financing without specific approval from the Investment Committee; **<u>except with respect to subscription facilities, credit enhancement, lines of credit and other financing vehicles the System may guarantee, if these financial arrangements provide economic benefit and only upon approval of the Senior Investment Officer of Real Estate</u>**. Acceptable collateral includes, but is not limited to, the System's wholly owned direct equity real estate or the System's partnership or joint venture interest.

<u>Analysis:</u>

Revolving Lines of Credit, of the type of which we are seeking clarification above, generally have 1 to 3-year terms, contain floating interest rates, are pre-payable without penalty, and the lenders generally do not look to the real estate assets as collateral but rather to the CalPERS guarantee. The potential liability of the revolving line of credit can be larger than the equity allocation the System has made to the partnership. Particularly in Non-Core programs where higher leverage levels are permitted. For example, a fund could have a \$100 million equity partnership allocation and a \$150 million line of credit with a CalPERS guarantee for a potential total commitment exposure of \$250 million to the investment. In this type of recourse debt, the lender would look directly to a guarantee from CalPERS, thereby resulting in CalPERS partnerships receiving much more attractive pricing on their borrowing facilities than otherwise. This kind of facility is anticipated to be used selectively in separate account relationships primarily in some of the separate account Opportunistic and International investment funds where it is economically advantageous to CalPERS to do so. Currently, the housing program has a total of approximately \$1.5 billion in lines of credit secured by capital call agreements, which could be interpreted as guarantees even though they don't carry the structure or title of a formal guarantee.

Benefits - The benefit of using such lines of credits with a CalPERS guarantee is significantly lower borrowing costs, which adds hundreds of basis points in overall return to CalPERS projects. In addition, at times it may be a way for CalPERS to obtain access to a transaction that it would not necessarily have been able to participate in otherwise. For example, in a mixed use project known as Time Warner Center (Columbus Circle) in New York City, CalPERS guaranteed part of the construction loan, and in addition to receiving a fee, CalPERS received an option to participate, at a pre-established cap rate (i.e. price), in part of the equity of the overall project.

Risks - The risks of guaranteeing a line of credit or some other debt accommodation is that, in a worst case scenario, CalPERS would be obligated to pay the amount of the debt that it has guaranteed, plus any accrued and unpaid interest. Reiterating the above example, a fund could have a \$100 million equity partnership allocation and a $150 million line of credit with a CalPERS guarantee for a potential total commitment exposure of $250 million to the investment and be obligated to pay this full amount. This risk is mitigated by the fact that CalPERS only guarantees projects where CalPERS has or is expected to have an ownership interest. Thus, any potential loss on the underlying debt would be mitigated by the value of the related real estate that CalPERS acquired with its investment in the partnership. Also, because CalPERS is in an equity position, it would have to step in to pay off any senior debt (recourse or non-recourse) in any regard in order to protect CalPERS' equity in the project.

Other financing vehicles could include situations where CalPERS guarantees portions of the outstanding debt as have occurred in the CURE program; for example it could be a portion of a construction loan or some upper portion of tax-exempt bonds placed on a multifamily project that CalPERS will have some major ownership interest in. The System guarantees are generally short to mid-term in nature (1 to 7 years) and the guarantee obligation generally decreases over the term. This has been used selectively for several years primarily with one of the CURE partners, CUIP. This facility is only used on projects where CalPERS has or expects to have an equity interest. Currently, there is approximately $450 million in this type of allocation that has been assigned to one CURE partner, CUIP, which will mainly be applied to the guaranteeing of some portion of tax-exempt bonds placed on multifamily projects.

The debt described above is important to have as it adds value to the System throughout the selective partnerships where such debt is deployed. These recourse debt structures are used solely in situations where CalPERS also has or anticipates having an equity position in the investment. Thus, staff seeks clarification from the Investment Committee that the selective use of such lines and/or other credit vehicles of the type noted above are permitted when approved by the SIO of real estate, solely when such use provides economic benefit to CalPERS and when operating within the 25% limit recommended.

Finally, attached is PCA's concurrence letter (Attachment 2). Staff and PCA will be available to address any questions the Committee may have.

V. STRATEGIC PLAN:

This item supports Goal IX to achieve long-term, sustainable, risk-adjusted returns.

VI. RESULTS/COSTS:

The agenda will clarify existing policy to make it more reflective of portfolio preferences, market practices, to provide more flexibility in a few areas, and to enhance performance activity within the affected real estate portfolios. The Statement of Investment Policy for Equity Real Estate Leverage governs both the Core and Non Core Portfolios.

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